Economic Growth and Development in Zambia: The Way Forward

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Abstract

Zambia has the advantage of abundant natural resources (many of which have not been developed), adequate fertile land, and the basic infrastructure to support modern economic growth. The conventional approach, however, has been to assume that Zambia needs additional resources if it is to grow and develop. History has clearly shown that resources are not the constraint in Zambia. Over the last thirty years, the country has had access to large amounts of domestic and external resources. These have produced regression rather than growth. It is important that Zambia use available resources efficiently, effectively, and equitably.

Doing this is the basic challenge facing Zambia as it seeks a way forward. Can the Zambian government respond to this challenge? Will the government respond? It could if Zambia’s leaders would make some consistent, coherent, and bold decisions about economic reform. After three decades of economic decline, what the government has to do is well known; whether it will do it remains uncertain. The suggestions the authors provide offer a means of reducing that uncertainty by helping Zambia find the way forward onto a path of rapid growth and development.

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Acronyms

ASIP – Agricultural Sector Adjustment Program
BoZ – Bank of Zambia
ESAF – Enhanced Structural Adjustment Facility
GRZ – Government of the Republic of Zambia
MMD – Movement for Multiparty Democracy
MoF – Ministry of Finance
PFP – Policy Framework Paper
RDC – Recurrent Departmental Charges
RAP – Rights Accumulation Program
UBZ – United Bus of Zambia
UNIP – United National Independence Party
ZAMTEL – Zambia Telecommunications
ZESCO – Zambia Electric Supply Company
ZCCM – Zambia Consolidated Copper Mines, Ltd.
ZIMCO – Zambia Industrial Mining Corporation
ZNOC – Zambia National Oil Company
ZPA – Zambia Privatization Agency
ZRA – Zambia Revenue Authority

1. The Way Forward

Zambia is a country rich in natural resources, but it has thus far not found a way to turn those resources into a reliable source of income for the country. In fact, losses in the mining sector have plagued the country throughout the 1990s. The difficulties encountered by the government of Zambia in its efforts to privatize the Zambia Consolidated Copper Mines Ltd. (ZCCM) have placed the Zambian economy under severe pressure. The sale of the mines according to the original timetable (full sale by mid-1997) would have potentially eased some of these pressures. However, as the prospects of the sale unraveled, there was a major loss of confidence in the economy. This was compounded by the loss of production in the mines, persistent concern over ZCCM's growing indebtedness, and the general collapse of commodity markets in the wake of the financial difficulties in Asia.

When judged against the government of Zambia's published assessments of the state of the economy, these difficulties and their knock-on effects took the government by surprise. For example, the 1998 Budget Speech (BS), delivered at the end of January 1998, had an exceedingly upbeat assessment of how the economy was performing and its future prospects (Economic Report Ch.2; BS 1998, pars. 16-49)[1]. Indeed, the Budget Speech presented a "medium term adjustment programme" through which Zambia could achieve macroeconomic stability, promote economic growth and reduce poverty.

In light of recent developments in the economy, many observers would suggest that the 1998 BS was unrealistically optimistic. The expectation that the Zambian economy was about to enter a melt-down phase had become widespread.

It is always difficult to assess the prospects of any economy when conditions are so fluid and expectations can change so abruptly. Our task in this chapter is to look beyond the day-to-day developments in order to determine what needs to be done over the short, medium, and longer term to promote and sustain rapid rates of growth and development in Zambia. We will do this by examining in depth the budget for 1998, its antecedents, and economic performance since then. We identify the strengths and weaknesses of the economy and highlight the measures that need to be taken if the Zambian economy is to be permanently moved to a higher growth path. We examine why the ambitious goals of the 1998 budget package were not met. Specifically, we consider the extent to which the 1998 budget provided a foundation for accelerating growth and reducing poverty. We consider whether the government's commitments outlined in the 1998 BS were consistent with the resources available and the policies and programs proposed.

If the economy is to move to a higher growth path and remain there, and we believe that it can, the factors responsible for the delays and reversals in policy need to be addressed, overcome, and prevented from recurring. The program we present in this chapter suggests how this might be done. We outline the steps required to accelerate the rate of economic reform in ways that will move the Zambian economy to a permanently higher path of growth and development.

We have arranged the material as follows. Section two contains background information about the Zambian economy. Sections three and four provide background for the 1998 budget. In section 5, we analyze the 1998 budget in detail. Following that, we present specific economic policy recommendations to help provide a foundation to the economy, build upon gains already made, and accelerate measures needed to fundamentally reform the economy. The final section offers concluding comments.

2. The State of the Zambian Economy

The government of Zambia has been attempting to structure its economic policy in ways that will promote rapid growth and development. The current political regime, the Movement for Multiparty Democracy (MMD), came to power in 1991. Its initial approach to economic policy represented a fundamental break with the past. The former government, in which the United National Independence Party (UNIP) was the only legal party, had relied on state intervention and controls to promote growth and development. By contrast, the MMD government sought to restructure the economy through the selective disengagement of government from the economy and the creation of a setting where growth and development would be led by the private sector. The MMD *Manifesto* provided a program for radical social and economic transformation.

The program involved several initiatives: liberalization of key markets; rationalization of the external debt; reorganization and reduction of the public service; privatization of state-owned enterprises (SOEs); revitalization of the mining sector; and reconstruction of the physical infrastructure. The government got the program off to a fast, though uneven, start. In 1992, the financial sector was opened up, maize meal subsidies were eliminated, resources were mobilized to begin reconstructing the transport infrastructure, the Zambia Privatization Agency (ZPA) was established, key changes in the tax code were introduced, and there was some easing of exchange controls.

Despite passing a balanced budget, the government did not impose budget discipline. Inflation accelerated and by September 1992 it approached an annualized rate of 200 percent. The Government responded by introducing a cash budget in January 1993. Together with the cessation of direct lending by the Bank of Zambia (BoZ) to selected (SOEs) and the full liberalization of interest rates, the cash budget created the conditions for a rapid decline in the rate of inflation. By the last half of 1994, the economy was stabilizing and there was evidence of a widespread supply response. The investment climate had improved dramatically and a renewed sense of confidence was emerging. The 1995 Budget Speech, widely acknowledged as a “growth budget,” reinforced the message that the Government was shifting its efforts from stabilization to growth.

In 1998, the Minister of Finance summarized the government’s goal as being to “…change Zambia forever…”. (BS 1988, par 5) Over the previous seven years, the government provided many explanations of how to do this. The 1998 BS presented a “medium term adjustment programme” (par. 2) through which Zambia could achieve macroeconomic stability, promote economic growth, and reduce poverty. These were ambitious and important goals. But in view of the start-stop approach to economic management it has proven difficult to reach those goals.

Table 1 has a broad overview of some of the key macroeconomic data. The early years provide the context for assessing the economy's performance during the 1990s. These data highlight the fact that the MMD government inherited an unstable, distorted, over-indebted, and regressing economy. In the period since 1992, real GDP has been flat. Gross domestic investment has risen marginally, funded by foreign inflows rather than gross domestic savings. The overall budget deficit has shown improvement, especially during 1996 and 1997. The share of exports in GDP has been stable (at around 30 percent), with nontraditional exports growing rapidly. By contrast, the share of imports has fluctuated, largely due to the sharp increase in foreign assistance after 1992. This is evident in the persistently large current account deficit on the balance of payments (over 10 percent of GDP). The nominal exchange rate has devalued, but much less than the domestic rate of inflation. Consequently, the real exchange rate has appreciated dramatically since 1993. The food production index, heavily dependent on maize output, has been generally flat mainly as a result of poor seasons. Taking population growth into account average food availability has declined during the 1990s.

Output in the copper sector has fallen due to the de-capitalization of the mines and general inefficiency (including asset stripping). Foreign aid to Zambia since 1992 has amounted to approximately U.S. $5.9 billion, the equivalent of 26 percent of GDP. Part of the aid has been used to reduce Zambia's external debt burden. However, due to the massive losses in the mining sector over the last two years, the volume of external debt, declining since 1993, has risen again.

Thus, in broad terms, the macroeconomic situation in Zambia since 1992 has been characterized by the persistence of unserviceable levels of debt, high inflation (especially relative to Zambia's trading partners), declining real per capita income, low savings and investment, declining per capita food production, and large inflows of foreign assistance. Even with the emphasis on reform since 1991, the Zambian economy remains distorted and lacks dynamism.

Looking more closely at these data reveals that there were some positive trends in the period 1992 to 1995, particularly with respect to inflation, interest rates, the exchange rate, and the growth of the money supply. All of these were moving in the appropriate directions. However, the momentum was lost[2] early in 1995 when the reform effort encountered serious difficulties, including problems of macroeconomic management and rates of progress in the reorganization of key institutions that proved to be too slow to support and sustain economic reform.

Problems in Economic Management

Several factors created difficulties for economic management in 1995. The collapse of Meridien BIAO Ltd., one of Zambia's largest commercial banks, disrupted fiscal and monetary policy. The abrupt end to the rains led to the failure of the maize harvest for the third time in four years. But perhaps the most important factor that diverted the government's attention from economic reform was the re-emergence of former President Kaunda as a political force following his re-election as leader of UNIP.

These events coincided with increasing resistance among Zambia's leaders to the donor community's conditionalities. The attractiveness of some of the government's commitments, which had been made in the full flush of the 1991 election campaign and which were contained in the MMD *Manifesto,* had dimmed over time. Donor pressure on the government to restructure ZCCM, close loss-making SOEs, the liquidate of the para-statal Zambia Industrial and Mining Corporation (ZIMCO), and observe principles of good governance and accountability, began to be seen as intrusions on Zambia's sovereignty rather than steps required to reconstruct the economy. Resentment intensified, especially after the donors insisted that the government close Zambia Airways as a condition for moving ahead with the provision of external assistance for 1995.[3]

The collapse of Meridien BIAO Ltd. resulted from mismanagement at the bank coupled with regulatory indulgence by the Bank of Zambia.[4] The government's support for the bank in advance of its collapse put severe pressure on the financial system. There was clear evidence that the economic program was going off-track. Senior officials in the ministry of finance were warned that this was happening in March 1995. The IMF mission staff independently provided a similar assessment the following month. No substantive action was taken.

The completion of the Rights Accumulation Program (RAP) with the IMF was postponed until September 1995 and a new set of performance criteria was agreed upon between the IMF and the government.[5] Short-term fixes were adopted to meet the end-September targets. These were not adequate to bring the economy back on a sustainable trajectory. Unfortunately, senior government officials interpreted the completion of the RAP and willingness of the IMF to proceed with an Enhanced Structural Adjustment Facility (ESAF) as an indication that the government policies were back on track. That this was not the case became apparent when six of ten performance criteria for the ESAF arrangement were missed at the end of December 1995, just three weeks after the program had been formally approved[6].

Macroeconomic management remained problematic during 1996 and 1997. The annual budget targets were met, but only after large and destabilizing first quarter deficits. These were offset by compression of budgeted expenditures, the accumulation of arrears, and *ad hoc* revenue measures. Few of the indicative benchmarks were met. The first formal review of the ESAF was not completed and the program lapsed in mid-1997. The IMF began a process of "staff monitoring" awaiting government action.

Institutional Reforms

There have been important initiatives taken to reform a variety of Zambian institutions since the 1991 elections. They include the establishment of the Zambia Revenue Authority (ZRA), the reorganization and re-capitalization of the Bank of Zambia, the closure of the Zambia Industrial Mining Corporation (ZIMCO), the ongoing attempt to privatize ZCCM, and the effort to restructure and reduce the civil service.

The ZRA was set up in 1994 as a means of raising the professional standards of the revenue services and sharply improving tax compliance.[7] The experience so far has been mixed. A VAT was successfully introduced in mid-1995, replacing a sales tax. It has eliminated double taxation problems, improved tax yields, and shifted taxes away from investment to consumption. Nonetheless, tax fraud remains a problem in Zambia, in part from continued political interference in tax administration. Customs and direct taxes have major compliance problems.

With the removal of exchange controls, roughly one-third of the staff of the Bank of Zambia became redundant. The bank was down-sized with greater emphasis placed on financial supervision and economic research. The quality of its staff and management of its operations have improved. Although more work is needed, substantial progress has been made at improving the quality of the monetary data. Following trends abroad, the Bank of Zambia Act has been revised to give the Bank more independence.[8]

Despite improvements in the institution itself, monetary policy has encountered problems in several areas. At one level, this reflects the fragility of institutional reform where many of the key decisions still depend upon the individuals involved. At another level, it reflects the pressures placed on monetary policy by inappropriate fiscal policies. Contrary to *stated* government policy, the Bank of Zambia has regularly intervened in the foreign exchange and Treasury Bill markets to influence exchange rates and interest rates. The apparent stability of the exchange rate, which depreciated against the U.S. dollar by less than 9 percent during 1997, despite major changes in economic fundamentals domestically and internationally, was the result of BoZ manipulation. One way this was achieved was by the BoZ (informally) instructing ZCCM on the rate at which it could sell foreign exchange. This “hands-off” form of intervention certainly gave the exchange rate the appearance of stability but it drastically compounded ZCCM’s difficulties.

The main problem stems from the Bank’s inconsistent objectives. In order to manage the monetary system, the BoZ has formally adopted targets for the money supply and international reserves. (These are also targets under the IMF program). Despite these quantitative targets, the Bank’s management has tended to focus on the (politically sensitive) movements in exchange rates and interest rates. In broad terms, the Bank’s policies have been designed to push interest rates down and to prevent the nominal exchange rate from depreciating. The former has led to problems with the growth of reserve money; the latter with the volume of international reserves. More important, it has led to appreciation of the real exchange rate. These policies are not sustainable in the absence of (as yet, unrealized) improvements in the balance of payments, the fiscal surplus, or total factor productivity throughout the economy. The result of the BoZ actions has been to undermine the stability of the economy. Inflation has remained high, foreign exchange reserves have fallen, there has been significant re-dollarization of activity as the business community, and international investors have lost confidence in economic management and the monetary system.

The MMD government came to office committed to reforming both the public service and the SOEs[9] Both reforms were considered necessary for improving the effectiveness of the public sector and restoring growth. There has been some progress in both areas. However, the key reforms have been continually delayed. ZIMCO and Zambia Airways were liquidated, but the mining sector remained largely in government hands. The government made a commitment to complete the privatization of the mines by June 1997. As this is revised (April 2000) the privatization has still not only just been completed.[10]

In the public sector, some reorganization has taken place. Again, however, the difficult reforms needed to reduce the size and wage bill of the civil service still have not been addressed. There were plans to retrench large numbers of civil servants during 1998 with a schedule of reductions included as part of the draft IMF program. However, the number of civil servants let go was smaller than expected because of accumulated leave that had not been adequately budgeted. No further progress has been made.

Key Strengths and Weaknesses of the Zambian Economy

On paper, the Government of Zambia's approach to economic reform has been bold, broad-based, comprehensive, and far-reaching. In practice, significant progress has in fact been made in a number of areas. However, there have been major problems in sustaining the pace of implementation of critical initiatives. In some cases, such as civil service reform, there has been little movement. With respect to ZCCM, major losses have been incurred while the government has been haggling over the sale price.

Notwithstanding these problems, some important achievements have been made which continue to move the economy in the direction of reform.

Areas of Strength in the Reform Program

Creation of the Zambia Privatisation Agency (ZPA) and the sale of state-owned enterprises. There has been considerable, justifiable praise for the accomplishments of the ZPA from the World Bank (1996), the African Development Bank (1997), and others. In its first two years, ZPA was ineffectively managed and out-maneuvered by ZIMCO. In 1995, the government liquidated ZIMCO and replaced ZPA's management. These changes greatly accelerated the pace of privatization. At the end of 1997, 213 companies had been privatized out of a portfolio of 326 companies (Economic Report 1997:p. 80).

Some privatizations have been highly successful. Examples include Zambia Sugar, Chilanga Cement, Zambia Breweries, Lintco (the Zambian cotton company), and Rothmans. The liquidations of some enterprises, especially of United Bus of Zambia (UBZ) and Zambia Airways, have directly stimulated private sector investment. Indeed, the demise of both the UBZ and Zambia Airways opened up the road and air transport sector to competition. This has led to widespread improvements in transport services.

The major failing in the privatization effort, discussed below, has been the delay in dealing with ZCCM. As a crucial element in promoting economic recovery, the sale of

ZCCM should have been the first item on the government's agenda. In fact, it has been almost the last.

The delay has been exceedingly costly to Zambia. Copper production has declined from 403,000 metric tons in 1993 to around 310,000 metric tons in 1995, 1996, and 1997. These production trends reduced export earnings especially in 1996 when copper prices declined from the high levels of 1995. In 1996/7, ZCCM reported losses in excess of $200 million.

Removal of exchange controls and liberalization of the financial system. Domestic interest rates were liberalized in January 1993 with the introduction of the Treasury Bill tender system. Exchange controls were eliminated by January 1994. Given Zambia's history of controls, these changes were revolutionary.[11] For the first time in decades, Zambia had market-determined interest and exchange rates and the basis for providing the appropriate incentives for resource allocation within the economy. These changes, which provided a mechanism by which resources could be induced to remain in Zambia rather than seek outlets abroad, were instrumental in helping to stabilize the economy during 1994.

Another area that required attention was bank supervision. The Meridien BIAO debacle highlighted the importance of routine, competent bank supervision. With changes in the Bank of Zambia Act in 1996, the legal basis for strict financial supervision now exists in Zambia. Useful changes have already been made. New capital adequacy requirements, consistent with international standards, have been applied. Judging from their swift response when Prudence Bank encountered difficulties in 1997, BoZ staff understand that regulatory indulgence is both costly and potentially embarrassing.

Improved data monitoring as a basis for economic policy. When the MMD took office, few relevant data were available on monetary and fiscal variables or the real economy. Starting in late 1992, government officials made a concentrated effort to improve the quality and timeliness of the macroeconomic data. A joint Data Monitoring Committee, consisting of staff from the Ministry of Finance and BoZ, was established in January 1993 to update key data and monitor them on a daily basis. Mechanisms were established to assemble and report the variables necessary for implementing fiscal and monetary policy. The work of this committee has given government policy makers access to timely data such as reserve money, international reserves, revenue, expenditure, and net claims on government on a daily basis. This has made it possible for the government to take the type of policy decisions needed to keep the reform program moving forward.

Further improvements in data collection and analysis could be made. Estimates of real economic activity are still unreliable and are available only after a long lag. The monetary data have improved significantly, but there are still problems with the government accounts at the BoZ. For example, there have been major problems reconciling the net claims on government data with the fiscal accounts. The BoZ does not routinely produce a monetary survey of the quality that will serve as a basis for macroeconomic management.

Restructuring the tax system. Zambian officials started the process of overhauling the tax system in 1991. The intention was to strengthen tax administration and restructure the tax system. Since then, many basic reforms have been implemented. Relative to its former structure, the tax system now has a wider base, lower rates, and fewer distortions. It has become easier to administer and more efficient and equitable. Noteworthy accomplishments include the introduction of a VAT, the liberalization of many trade taxes, and the reform of mineral taxation.

Zambia successfully replaced the sales tax with a VAT in mid-1995. A tax policy task force was established in 1992 to advise the government on reforming the tax system for the 1993 budget and beyond. It recommended the switch to a VAT and provided the preliminary groundwork for the transition. A VAT Implementation Committee was set up, chaired by the Minister of Finance with members from the Ministry of Commerce, Trade and Industry, and the Zambia Revenue Authority to oversee the introduction of the tax. The VAT was intended to broaden the tax base, eliminate the distortions created by the cascading of the sales tax, improve the competitiveness of Zambia's exports, and shift the tax burden from investment toward consumption. The performance of the VAT in its first year was relatively successful. Revenue collected was close to projections and above the revenue previously collected under the sales tax.

Zambia has also implemented a major trade liberalization program over the last seven to ten years. Exchange controls, import licenses and quotas were removed, leaving tariffs as the major remaining restriction on trade. Over time, tariffs have been systematically reduced, further liberalizing trade. In 1991, the maximum tariff was reduced to 50 percent. In 1997, the top rate stood at 30 percent (including the 5 percent Import Declaration Fee). The government has been committed to further liberalization. Nonetheless, manufacturers lobbied (successfully in some cases) to prevent further liberalization and to reintroduce *ad hoc* protection for certain sectors.

Mining sector tax policy was also modified in anticipation of privatization. A task force was established whose recommendations to modernize the tax treatment of the mining sector led to a revised Mines and Minerals Act in 1995. During the negotiations for the privatization of ZCCM, potential buyers were demanding more favorable treatment than contained in the revised laws. The government responded to the pressure by further revising some of the mineral tax laws in favor of potential buyers. For example, the 1998 BS announced four additional concessions. The mineral royalty tax was decreased from 3 to 2 percent, the period of carry forward of losses was increased from 5 to 10 years, the withholding tax rate on interest and dividends was decreased from 15 to 10 percent and "ring fencing" of investments was removed. The revenue loss was estimated at K18 billion ($9.7 million) annually (BS, par. 116).

Reductions in Inflation, the Cash Budget, and Aggregate Budget Discipline. Measured on an annual average basis, inflation declined from 187.3 percent in 1993 to 43.5 percent in 1996. During 1997, inflation declined further to 24.8 percent. The overall downward trend in inflation was achieved, dramatically at first, through the introduction in January 1993 of a cash budget. The intention was to ensure that the budget would not be a source of money creation. The latter had been the principal cause of inflation in Zambia over the previous two decades.[12]

Initially, the cash budget rule meant that non-interest expenditures would be made only if the government had adequate resources in its account at the Bank of Zambia. During 1993, interest on domestic debt was financed through the sale of Treasury Bills, permitting an overall domestic budget deficit. But, beginning in 1994, interest on the domestic debt was paid out of government revenue, rather than by additional borrowing. During 1996, the government budget called for a domestic surplus of 1 percent of GDP, which was achieved (K53.4 billion surplus). During 1997, the government ran a surplus of K80 billion, or 1.5 percent of GDP.[13]

The budget is no longer a source of rapid monetary growth and a cause of high inflation. Even with this progress, some substantial pressure has remained. To illustrate, the stock of Treasury Bills and Bonds increased by K88.2 billion during 1995, K27 billion during 1996, and K18.6 billion during 1997 (Macroeconomic Indicators 1998:Table 5.1). On balance, these improvements have to be put in the context of the creation of government debt that are not noted in the official statistics. These include the annual cycle of arrears on the budget (K68.7 billion in 1997); the BoZ foreign exchange transfer to government (around $150 million by mid-1997); and the official commitments to support ZCCM operations (amount unknown).

Areas of Weakness in the Reform Program

Distortions in fiscal management. The problems of fiscal management include the breakdown of the cash budget, persistent data inconsistencies, domestic arrears, tax expenditures by SOEs, and distortions in the allocation of public expenditure. We address these issues one at a time below.

<u>Cash Budget</u>: During 1996 and 1997, the government moved away from implementing the cash budget on a day-to-day basis, and instead attempted to comply with it on a monthly basis. Senior MoF officials argued that the daily implementation of the cash budget led to difficulties in the "orderly" financing of ministries and departments. Because the MoF had to wait for revenues to accumulate during the month before fundings could be made, the regular operations of ministries were disrupted.[14] To deal with this problem, it was agreed to make fundings at the beginning of each month based on projected revenue. Any shortfall that arose during the month, i.e., when expenditure exceeded revenue, would be covered by a temporary bridge loan from the BoZ which would be repaid by the end of the month as revenues came in. This type of arrangement was considered necessary because the government could not generate a small surplus at any point to cover the cash flow needed in the following months.

This arrangement worked for some months in 1996. In other months, the bridge loan was not repaid. Thus, even the "relaxed" version of the cash budget was breached. As a result, expenditures were no longer constrained to be less than or equal to revenue. Expenditure control and pressure on the MoF to raise revenue both declined. The MoF increasingly became unwilling to take measures to enforce the cash budget on a monthly basis and the discipline it had imposed disappeared.

During the first three months of 1997, the new relaxed bridge loan procedures continued and the government ran a deficit of K31 billion ($23.6 million). Under a day-to-day implementation of the cash budget, this would not have been possible.

Data Inconsistencies: Another problem is that the fiscal position reported by MoF does not match the fiscal position reported by BoZ. This discrepancy has persisted for several years and no satisfactory way to reconcile the two has been found.

The BoZ net credit to the government data in 1996 and the first quarter of 1997 suggest that the government has run a smaller surplus/larger deficit than reported by the Ministry. In 1996, the Ministry of Finance recorded a surplus of K52.3 billion, while the net claims data showed a surplus of roughly half that amount. In the first quarter of 1997, the Ministry of Finance reported a deficit of K17 billion, while the net claims on government calculations indicated a deficit of K31 billion. Similar inconsistencies persisted throughout 1997.

The general presumption is that the BoZ data are more reliable. If so, some unrecorded government expenditures are occurring on a systematic basis. One implication is that expenditure shares by sector are incorrect, raising questions about exactly what expenditures have taken place and through what channels. Yet, the discrepancy could be in the BoZ data, a possibility no more reassuring.

Data problems also prevent the BoZ from regularly compiling a monetary survey. Beginning in 1988, major discrepancies emerged in the BoZ accounts. Because of these discrepancies, the Bank did not release audited accounts for several years. An intense accounting effort, begun in the early 1990s, identified discrepancies on both sides of the accounts. These could not be fully reconciled due to the loss of key records. The BoZ subsequently published a "statement of affairs"(Bank of Zambia 1994).[15] The Bank of Zambia has now returned to its earlier practice of releasing audited accounts.

Despite these data problems, major improvements in the timeliness, quality, and general availability of the basic macroeconomic indicators have occurred since 1992. But the availability of better data is a necessary not a sufficient condition for improved policy.

Domestic Arrears: A third problem with fiscal policy is domestic arrears. Although the initial impact of the cash budget was dramatic, its effect was only to contain aggregate expenditure. The basic rule was that the MoF would not fund expenditures unless revenues were available. Although they were instructed otherwise, this did not stop other ministries from making commitments before they had been funded. The outstanding bills created a large backlog of arrears. These commitments were often made against expected fundings. If revenues were not forthcoming, or the government made expenditures on unbudgeted items, ministries would not receive the amounts they had expected.

To date, the government has not had an adequate mechanism for measuring arrears and dealing with them. Each ministry is meant to report commitments to the MoF on a monthly basis. In principle, funding is meant to be withheld until this requirement is fulfilled. Compliance is low and since the MoF has no independent information on whether the amounts reported are accurate, there is no effective basis for imposing penalties on ministries that do not comply.

One implication is that the measured surplus during any period is overstated by the amount of increase in outstanding bills or arrears. In 1995, the amount outstanding was estimated to be as high as K50 billion. During 1996, K42 billion in arrears were paid. In 1997, K68.9 billion in arrears were paid. The surplus reported on the domestic budget in 1997 of K80.2 billion must be reduced by any new arrears incurred during the year.

The government could have avoided arrears by issuing additional Treasury Bills. Instead, the private sector was unilaterally induced to extend credit to the government. While both approaches result in crowding out, the latter is both arbitrary and disruptive of attempts to achieve fiscal discipline.

Tax Expenditures by State-Owned Enterprises: Officially, the Government does not support any SOEs through the budget. But several SOEs have large outstanding tax arrears to ZRA. As of mid-1997, estimated arrears to ZRA from Zambia Electric Supply Co. (ZESCO), Zambia National Oil Co. (ZNOC), Zambia Telecommunications (ZAMTEL), and ZCCM exceeded K50 billion ($38 million). In ZESCO's case, the arrears were largely the result of financial problems at ZCCM which was not paying its electricity bills. In the case of ZNOC, arrears have resulted from continued government intervention in the operations of the company in order to manipulate the price of petroleum. The government taxes the oil sector but it does not allow ZNOC to increase its prices adequately to cover its expenses (including the tax). This situation persists because political pressure has prevented ZRA from treating ZNOC (and other SOEs) as it would treat a private company.

Allocation of Public Expenditure: Although the cash budget provided a framework for bringing aggregate expenditure under control, the allocation of government expenditure has remained problematic. Wages and salaries dominate current expenditure because so little progress has been made on public sector reform. The civil service is too large and too poorly paid. At the same time, the civil service wage bill continues to increase as wage settlements exceed the rate of expected inflation. Since salaries must be paid, discretionary expenditures have been compressed. Accordingly, the allocations for capital expenditures have fallen short of budget in each years from 1994 to 1997. Funding for recurrent departmental charges (RDCs) was below budget in 1996 and close to the budget in 1995 and 1997. As inflation was higher than anticipated in both years, real allocations were significantly below budgeted amounts.

The entire system of budgeting in Zambia – both the level and the allocation of government expenditure – needs overhaul. Currently, there is little timely follow-up on the allocation of expenditures by ministries. Funding is not matched against actual expenditures to ensure that ministries allocate their resources appropriately. Similarly, there are few data on the size or allocation of domestic commitments by ministry. Until this situation is addressed, the pattern of government expenditure derived from funding data can only provide an imprecise view of how spending is being allocated across ministries and departments.

Little support is currently forthcoming from either the Auditor General or the Accountant General. The former is several years behind in auditing the government accounts, primarily because the Accountant General's office is several years behind in producing them.

At present, the MoF is taking steps to monitor commitments and arrears and plans to move toward a fiscal management information system as quickly as possible. Realistically, such an operational system is still some years away.

Problems relating to the conduct of monetary policy. Even with these fiscal problems, the domestic budget has not been a major source of money creation relative to the period up to 1992. This has improved the context in which monetary policy is conducted. However, several problems remain. Reserve money grew by 62 percent in 1996. Monetary growth was lower, at 28.3 percent, but primarily because of a widespread shift into currency and because of an increase in the required reserves at the commercial banks. Both changes had a negative effect on financial intermediation. The increase in reserve requirements in 1996 partially reversed the financial liberalization achieved up to that time.[16] Higher reserve requirements merely raise the tax on financial intermediation. They do not address the underlying cause of the rapid growth in reserve money. During 1996, reserve money grew because of lending by the central bank to a number of commercial banks that experienced liquidity problems. It also increased because of foreign exchange purchases that the BoZ would not sterilize because it was unwilling to accept the interest rate consequences of such action.

In 1997, reserve money grew by 26 percent and the money supply by 22 percent. During the first four months of the year, international reserves declined by $40 million. If the BoZ had attempted to replace these reserves by purchases from the market, reserve money would have increased significantly. The exchange rate would have had to depreciate. But, to offset the rise in reserve money, the BoZ could have sold additional treasury bills. This, however, would have raised interest rates at a time the government wanted them to fall. The inherent conflicts remain of attempting to meet quantitative targets while containing the consequent price movements. For the last part of 1997, the government ran a large surplus thereby easing pressure on reserve money. This enabled the BoZ to buy foreign exchange without undue pressure on the money supply and interest rates. If fiscal policy does not move toward a large sustained surplus, the conduct of a constructive monetary policy will be extremely difficult. In particular, it will not be possible to the control money supply without driving interest rates up or depleting international reserves further.

These policy conflicts raise issues about official management of both the exchange rate and interest rates. During 1997, interest rates fell continuously, despite an increase in the Treasury Bill stock of over 10 percent. A possible explanation might have been a decline in inflation expectations. If is difficult to infer that inflation was generally expected to fall. Another possibility is official manipulation of interest rates through BoZ "suggestions" to commercial banks that they lower their rates or be left holding cash.[17] Since any positive Treasury Bill yield is preferable to cash, the banks made the obvious choice. Yet, as interest rates were pushed down, banks were offering deposit rates that were no longer attractive. Real interest rates had become significantly negative.

Similar problems emerged with the exchange rate. Despite the government's regular official assertion that the exchange rate is market determined, there is significant evidence to the contrary.[18] The basic issue is that the government is formally committed to a reserve accumulation objective. Its market participation should therefore tend to put pressure on the exchange rate to depreciate. Nonetheless, in the first quarter of 1997, foreign reserves declined sharply even though the ESAF agreement with the IMF called for the opposite to happen. Evidently, concern about depreciation of the exchange rate dominated the choice of policy response. The result, however, is that the nominal stability of the kwacha achieved by the BoZ has led to a marked appreciation of the real exchange rate. This is not in Zambia's interests. Nor is it consistent with economic developments. With donor flows declining, copper export earnings falling, and widespread uncertainty in local and global financial markets, Zambia requires a major real depreciation of the exchange rate. The government has unwisely resisted this. Nevertheless, it is now being forced on the system through the re-emergence of a parallel foreign exchange market. This has created a major credibility problem for the government and the BoZ.

Delays in the implementation of the civil service reform. The MMD government came to office committed to reforming the civil service. It recognized that the civil service was overstaffed, putting pressure on the budget, at the same time that civil servants were paid too little. Good people were hard to retain and those who remained lacked motivation to perform their jobs effectively, often taking extra jobs to make ends meet. Much staff time and ingenuity were being used to exploit the government's benefits system to increase compensation above the base salary. While real wages are low, the share of spending going to personal emoluments has been increasing. There has been no progress on reducing the number of employees. At the same time, there has been intense pressure on the wage bill.

Table 2. Zambia: Trends in Major Items of Government Expenditure (millions of Kwacha)

Year	Personal Emoluments (PE)	Domestic Interest	Capital Expenditures	RDCs	RDC/PE (%)	PE in % of total domestic expenditure
1989	..	1,006	3,160	..	..	..
1990	5,960	1,584	7,059	5,157	86.5	30.2
1991	13,272	3,662	11,758	8,846	66.7	35.4
1992	34,045	15,577	21,464	20,907	61.4	37.0
1993	70,529	71,463	46,889	54,425	77.2	29.0
1994	92,188	102,538	89,173	63,181	68.5	26.6
1995	151,262	77,029	154,256	100,672	66.6	31.3
1996	201,497	121,846	231,196	119,636	59.4	29.9
1997	324,228	115,229	534,583	140,027	43.2	29.1

Sources: IMF (1997), Ministry of Finance and Economic Development (1998), World Bank (1997)

The personal emolument component of government expenditure is reported in Table 2. With government expenditure compressed to meet budget deficit targets, a rising share of personal emoluments, along with high interest expenditures, has severely compressed RDCs and capital expenditures. Although the government is committed to investing in infrastructure, health, and education, in fact personal emoluments and interest expenditures have claimed an increasing share of government expenditures.

At the beginning of the public service reform program in 1993, the government indicated that it would reduce the size of the civil service through attrition, pending the adoption of an overall reform strategy, including retrenchments. The policy was to limit new hires to one person for every three who left. With deaths, retirements, and voluntary separations, this approach was expected to shrink the civil service by a noticeable margin each year. Instead, civil service employment rose from around 124,000 at the end of 1996 to close to 140,000 by end-December 1997.

The lack of progress on civil service reform has had a major negative effect on the management of key ministries. Building capacity has proven to be extremely difficult. Capable managers rarely remain in the civil service and most ministries lack any depth. Senior officials, few of whom have any formal management and supervision training, have been attempting to promote reform in a system which is poorly organized and where staff are generally demoralized.[19] Any staff members who have some capacity, technical or otherwise, tend to be over-loaded with work.

Under the public sector reform program, the structure of most ministries has been examined and modified. Redundant staff have been identified and some basic reorganization has occurred. For example, the National Commission on Development Planning (NCDP) was re-merged with the Ministry of Finance. But, by the end of 1997, little of substance had been accomplished and the public sector reform program had stalled. There was some discussion, without much progress, about restructuring ministries and sending excess staff home at full pay. Some progress on reducing the numbers of civil servants was made in 1998. The problem, however, is funding. As noted below, the bulk of the budget commitment depends on donor support.

Limited attention to tax fraud. While implementation of tax policy reform has been impressive, it has not been matched with corresponding improvements in tax administration and improvements in compliance. The ZRA, in limited ways, contributed to improved collections. But, for direct taxes and customs, the creation of an independent authority has not led to the elimination of political interference, which is needed to deal effectively with fraud. When viewed in broad terms, tax collections have not improved significantly. Indeed, in real terms, direct taxes and excise taxes were well below projections in 1995, 1996, and 1997.

In the 1998 BS (pars. 143, 145), the Minister of Finance admitted that tax fraud is a major problem. The government offered a tax amnesty as a means of helping construct the records needed to improve collections. Initial indications are that the response has been significant. The long-term effects on revenue are not clear.

Some indication of the scope of the fraud problem is evident in the aggregate data. An obvious index is that revenues relative to GDP have declined even though the government has an explicit program to raise that ratio. Table 3 reports revenue performance since 1991. Real revenues declined in 1995 and 1996, relative to 1994. Revenue as a share of GDP also declined, from 19.8 percent in 1994 to 19.3 percent and 18.3 percent in 1995 and 1996 respectively. It recovered some in 1997, but is still 1 percent below the 1994 share.

Table 3: Tax Ratio, Real Tax Revenue (1994 prices) and Tax Collections Relative to Projections

Year	Tax Revenue (1994 prices)	Percent of GDP	% above or below projections
1991	K524,933	18.4	na
1992	K471,939	18.8	na
1993	K347,157	14.1	na
1994	K418,879	19.8	+5
1995	K406,980	19.3	-5
1996	K389,600	18.3	-12
1997	K403,175	18.8	-2

Source: *Macroeconomic Indicators* (various issues), Budget Speeches, 1994-1997, and calculations by the authors.

ZRA managers have regularly claimed that they have met and exceeded all revenue benchmarks. However, there has been confusion between real and nominal benchmarks. In real terms, the revenue targets included in the annual budgets for the years 1995-1997 were not met.

Failure to Privatize ZCCM. The decision to privatize ZCCM was politically difficult. ZCCM has been widely seen as Zambia's crown jewel. Yet, the value of ZCCM as a national asset has deteriorated sharply.[20] Once the government made the decision to sell ZCCM, the national interest would have been served by completing the process as quickly as possible and monitoring the company's performance as it was being sold. Neither has occurred. After two years of preparation, the government stated that the full privatization would occur during 1997. In fact, the sale did not take place until March, 2000. In the meantime, the financial and physical performance of the company has deteriorated dramatically. This represents a direct loss to the country, in terms of foregone GDP and higher debt. It also imposes losses on the government through a reduction in current tax revenue and reduced sale proceeds. Many of these costs will continue into the future because of the tax concessions granted to finalize the privatization and servicing of the debt being accumulated by ZCCM.

Continued Interference in Agriculture. Agriculture accounts for around 20 percent of GDP and 70 percent of employment (World Bank 1998). The bulk of Zambia's poverty is in agriculture and in the rural areas (UNICEF 1995; World Bank/Government of the Republic of Zambia 1995). Any strategy to reduce poverty and raise the overall rate of economic growth will require the revival of agriculture. The government's stated policy has been to liberalize agriculture. Its actions, however, have been otherwise. A good start was made in 1992 with the removal of subsidies on maize and attempts to reform the maize marketing system. The government subsequently made the commitment to liberalize product and input marketing in agriculture. This policy has never been fully implemented. For example, exports of maize were banned in early 1996. Wheat imports were banned in 1997. Because of the mixed signals, the response of the private sector to the "new" marketing opportunities has been cautious.[21]

Summary. The Zambian economy is presently under intense pressure. Some of this pressure is due to the inability of the government to sell ZCCM's assets. Some of the pressure has been generated by the delays and reversals in policy reform which have occurred particularly since early 1995. These factors make it difficult to be upbeat about the economy's immediate prospects. There are, however, some positive elements that provide cause for optimism about the medium term prospects for Zambia. These elements include a number of reforms – price liberalization, financial reform, privatization, tax reform, and trade liberalization – which have demonstrated (sometimes in bold terms) that economic reform will succeed if the government remains fully committed to measures needed to sustain the reforms.

In the next section we examine the extent to which the policies and initiatives in the 1998 budget contributed to economic reform. Our assessment indicates that some of the important elements needed to boost reform have been identified. However, others are still needed.

3. General Background to the Budget

In order to understand what is presented in the BS, it is useful to set the context with some history. The 1992 budget was the first opportunity for the MMD government to formulate its own economic policy. That budget was designed to move beyond the disorganization and deficits that characterized the one-party state. It aimed to stabilize the economy *and* begin the process of economic reform. The main initiative was to balance the budget so as to sharply reduce inflation. Yet, within months the government had made unbudgeted wage adjustments, granted subsidies to Zambia Airways, and spent heavily for drought relief. The budget deficit expanded and the rate of inflation accelerated.

This was a major embarrassment for the new government which had sought to distinguish its policies from those of its predecessor. Declaring inflation to be the "cruelest tax on the poor", President Chiluba committed the government to act decisively to reduce inflation. The 1993 budget focused on that objective. A cash budget mechanism was introduced. With tight monitoring, the cash budget achieved its goal of matching expenditure to revenue. Inflation declined sharply. By year-end, economic stabilization appeared to be well in hand. The budget in 1994 was seen as a transition to high, sustained rates of growth. Tax reform, introduced in 1993, was continued, the Zambia Revenue Authority was introduced, plans were made for major reductions in external debt, and the government made commitments to reform ZCCM and the public service. Major economic improvements occurred during 1994. The exchange rate stabilized, monetary growth was low, the budget generally remained in balance, and interest rates (which started the year at an average annual rate of around 400 percent) fell dramatically. It appeared that Zambia was about to achieve the stability and growth that had eluded the country for more than two decades.

The 1995 budget was devoted to growth. Tax reform was continued, strict limits were placed on the government wage bill, and plans were made to expand capital expenditure. The government expected to complete its Rights Accumulation Program (RAP) with the International Monetary Fund (IMF) by March 1995 and receive generous debt relief from the Paris Club. Yet, within two months of having been presented, the budget had unraveled for the reasons given in the previous section.

Under pressure from the IMF to bring the program back on track and complete the RAP, the government took steps in mid-1995 to raise additional revenue and reduce the budget deficit. These measures enabled the government to meet a new set of benchmarks for the end of September. This completed the RAP and provided Zambia with the opportunity to move to the Enhanced Structural Adjustment Facility (ESAF) arrangement. That arrangement was approved by the IMF Board on December 4-6th 1995. However, at end-December 1995, just three weeks later, the government missed six of the ESAF's ten performance criteria.

The government could have used the 1996 budget to rationalize its approach to macroeconomic management. This was not done with the result that the IMF program remained off track. Monetary control became increasingly problematic under the pressure of BoZ transfers to government to cover the shortfall in external debt service. These pressures intensified following the suspension of bilateral donor disbursements when government changes in the constitution were seen as breaching acceptable standards of governance.

By the time the 1997 Budget was formulated, the MMD government had been re-elected with an overwhelming majority and President Chiluba had been reaffirmed for a second term. Negotiations appeared to be well under way to sell ZCCM. The previous agricultural season had been generally satisfactory. The prospects for substantial economic expansion existed. Unfortunately, the 1997 budget did not address the basic problems facing the economy. This became increasingly clear as the year progressed. Three specific factors proved disruptive. The government had not resolved its differences with the bilateral donors in ways that would rationalize the flow of aid. The copper price fell sharply in the wake of turbulence in world financial markets. And, the sale of ZCCM continued to be delayed.

This was the background against which the 1997 and 1998 budgets were framed.

4. Budgetary Allocations, 1997

The 1997 Budget helps illustrate several points about the government's overall approach to macroeconomic management. The following table provides the budgeted and actual revenues and expenditures for 1997.

Several points are noteworthy. First, tax revenue performance exceeded expectations by 5.3 percent in nominal terms. Second, non-tax revenue was significantly below estimates. This is not a new problem. As early as 1994, it was clear that action had to be taken to redress this problem. Third, overall domestic expenditure and net lending , before the payment of arrears, was less than budgeted. Fourth, the allocation of expenditure was markedly different from the budgeted composition. In particular, wages and salaries were higher than projected and capital expenditure was lower. Fifth, overall the domestic target for surplus was achieved.

Budgeting is always based on estimates. Therefore, it would be unreasonable to expect that there will be no deviation throughout the year. The major issue, however, is the direction of deviation and whether it represents a departure from past trends or indicates that the budget is moving in ways that are sustainable. Based on these considerations, the Zambian budget has been fundamentally off-track. Furthermore, none of the changes made in 1997 indicate that it was moving in ways that would bring it back on track.

Table 4. Central Government Budget Performance 1997, K billions

	1997 Budget	1997 Actual
Domestic Revenue	1000.2	1028.4
Tax revenue	919.7	968.4
Non-tax revenue	80.5	60.0
Domestic Expenditure and		
Net lending	938.8	893.4
Recurrent domestic expenditures.	715.8	822.5
Personal emoluments	249.2	324.2
RDCs	145.6	140.0
Transfers and pensions	130.1	164.2
Interest on domestic debt	91.0	115.2
Other current expenditure	99.9	57.7
Contingency	100.0	21.1
Capital expenditure	122.5	70.8
Surplus/Deficit (accrual)	62.0	135.0
Payment of arrears (net)	0	68.9
Change in balances (net)	0	14.1
Domestic Balance (cash)	62.0	80.2

Source: *Economic Report 1997,* Table 2.6

The government's estimate of nominal GDP in 1997 was K5157 billion. Thus the tax revenue collections amount to approximately 18.8 percent of GDP. Relative to former years, this is a slight improvement, largely reflecting the shift in management of the Zambia Revenue Authority. In real terms, however, the improvement in revenue collection shows no growth. The budget was framed on the expectation that inflation would be 15 percent by December 1997. Average inflation in fact was 25 percent. Therefore, real tax revenues were 2 percent below projection [how does this follow?].

The poor performance of non-tax revenue – fees, fines, user charges, and so on – represents a continued failure to ensure that the revenue due to government from non-tax sources is collected. This has been an important deficiency in governance.

This problem, however, is relatively minor compared to the distortions in the expenditure side. From past performance in Zambia, the distortions are predictable. Personal emoluments always exceed the budgeted amount and capital expenditure always falls short of the budgeted target. Thus, the budget does not serve to balance recurrent and capital expenditure. Moreover, the over-expenditure on wages is not matched by a comparable increase in expenditure on operations and maintenance. This simply perpetuates the recurrent cost problem that has been a feature of government expenditure in Zambia since the economic crisis began in the mid-1970s.[22]

One of the curious items in the 1997 expenditure is the payment of K68 billion in arrears. The budgeted total was zero. Based on the history of budget management since 1993, the first year when cash budgeting was attempted and, consequently, the first year that arrears became a problem, the budgeted figure was totally unrealistic. However, it is not clear that the K68 billion was entirely arrears. One explanation is that additional unbudgeted current payments were made and labeled as arrears, the clearance of which was agreed with the IMF. Such speculation could not arise if the budget were transparent. The basic test, however, will be whether the government's domestic arrears have been fully discharged. Most observers expect that they have not. The implication, of course, is that the domestic budget surplus, when measured on a commitment basis, has been considerably less than the cash surplus.

One of the interesting anomalies in the budget is the under-estimate of the domestic interest payments relative to the amounts actually paid. The error should have been in the other direction since the stock of government debt was known at the start of the year. The projected re-capitalization of the BoZ was also known (having been announced in the 1997 BS), and interest rates fell more rapidly than had been anticipated. By understating interest payments, overall expenditure appeared to be lower. This strategy ensured that the government would require less "up-front" action to raise revenue or cut expenditure. (The same comment applies to the under-statement of wage and salary payments.[23])

A final point that is worth noting is that, contrary to several statements made by the minister in the 1998 BS, the domestic budget "surplus" was not used to retire domestic debt. Total domestic debt (T Bills and bonds) increased by K38 billion ($28.9 million) during 1997. When grants (which reduce funding requirements) and external debt service (which increases them) are taken into account, the government ran a budget deficit.

None of these manipulations would matter much if they were one-off adjustments to accommodate urgent pressures on the budget. This has not been the case. The adjustments --- the under-collection of non-tax revenue, the over-expenditure on wages and salaries, the under-spending of capital, the miscalculation of domestic interest payments, and the payment of arrears --- all fit a pattern in which the budget has been conveniently manipulated. Since these manipulations have been in directions that inflate recurrent wage-based expenditure and deflate capital expenditure, the budget continues to be a prominent example of macroeconomic mismanagement in Zambia. The net effect is to erode rather than enhance Zambia's capacity for growth and development.

5. Overview of the 1998 Budget

The goals contained in the BS are exceedingly ambitious and wide-ranging.[24] There are new initiatives (poverty reduction, housing, road reconstruction) as well as the reconfirmation of several earlier commitments (privatize ZCCM, reform the public service, and decontrol petroleum marketing). Precise goals are given on the extent to which poverty will be reduced (par. 16), the dollar amounts by which per capita expenditure on health will rise (par. 89), and the rate at which the revenue/GDP ratio will increase over time (par. 115).

The basic question, however, is whether the 1998 budget, which the Minister noted was the "key instrument of government policy," represents the "…consistent, systematic, and evolving approach to economic policy which the Government has been pursuing for several years" (par. 150). By tradition, budget speeches typically stretch the limits on hyperbole. After all, its presentation is the one time each year when the government has the opportunity to lay its programs before a national audience. Though hyperbole has its uses, government officials also need to be pragmatic. Therefore, it is useful to delve more deeply to determine the policy changes that, given the government's capacity, can be implemented and sustained. In the following sections we do that by reviewing the budget using three criteria: scope, consistency of the message, and funding. We find that the budget includes the most important policy initiatives needed to put the economy on a path to sustained growth and development. But, it includes too much else at the same time, blurring the message and casting doubt on the degree to which the basic policies can be implemented.

Scope

The BS makes many commitments. New action is promised on housing, roads, electricity (par. 56), and poverty (pars. 56, 83). A number of earlier promises are revived.[25] The BS itself notes that the government believes the most effective way to reduce poverty is through rapid economic growth (par. 83). We believe that this should be the focus of government policy. Accordingly, we see a major danger that other efforts to deal with poverty (such as the National Poverty Reduction Action Plan) pose a serious risk of distracting the government's attention. In our view, the government should direct its programs in ways that sharply accelerate growth. It should not dissipate its energies on poverty reduction initiatives that from the start are inadequate to the task.[26]

The BS states that the government is committed to "…reduce the proportion of 70 percent of the population living in poverty to 50 percent by the year 2004" (par. 16).[27] Achieving this worthy goal will require that several assumptions hold. Population growth will have to remain below 2 percent per annum (the present World Bank projection) (World Bank 1998); real income growth of 5.5 percent per annum will have to be sustained until 2004 (and beyond); and there can be no worsening of Zambia's income distribution. But, real per capita income has declined sharply since 1992. According to *Macroeconomic Indicators*, it declined by 14 percent over the period 1992 to 1997. What has happened now that will so dramatically transform Zambia's growth prospects enabling this historically rapid increase in real per capita income to materialize? The BS provides no clear explanation. Indeed, that question becomes even more relevant because some of the assumptions made for 1998 --- 5.5 percent real growth and 9 percent inflation --- appear to be unattainable.

A specific direct anti-poverty allocation of K1.1 billion ($590,00) was made in the budget to support "empowerment programmes" (par. 107). This is a trifle amount in view of the enormity of the problem. It might have been seen as a useful start if other government policies supported poverty reduction. Yet, the government intended raising the tax on second hand clothes as a means of responding to the "complaints of textile producers" (par. 124). Such a policy does nothing to help the poor.[28] Moreover, it would have compounded the damage done earlier (September 1997) when a ban was placed on importation of wheat flour in response to pressure from the recently-privatized milling company. None of these actions is consistent with the Minister's claim that the government is making a "… concerted attack on our poverty…" (par. 155).

Consistency of the Message

The messages in the BS are mixed. An example, just discussed, is the approach to poverty reduction. There are others. The donors are commended for their assistance (par. 5) and then criticized for withholding support when the government did not met the conditions on governance to which it agreed (pars. 101, 102). The government promises to reduce the civil service through a hiring freeze (par. 93) yet presents a set of initiatives that may require more staff. To demonstrate this point, we discuss the relations with donors as an example in greater detail.

In the opening paragraphs of the BS, the Minister stated that the government was "… profoundly grateful to our international cooperating partners…" (par. 5). Further on, the expression of gratitude turned to criticism. Specifically, the Minister noted that by insisting that Zambia observe criteria of good governance the donors are "…putting in question the basis of our development cooperation partnership…" (par. 101).

In principle, Zambia's policy makers could adopt policies to meet its growth and poverty reduction goals without resources from the donor community. But for this approach to begin to be credible it would require a budget that does not include donor contributions. The 1998 consolidated budget, however, includes large amounts of donor resources. Moreover, the BS itself does not provide any suggestions of how the budget will be modified if the anticipated donor support fails to materialize. Thus, despite its criticism of the donors, the government expected the donors to fully supplement the budget.

What is lacking in the BS is recognition by the government that, although the donors made a general commitment to support economic reform in the mid-1980s, they still care on an ongoing basis about the way their assistance is used. On this point, it is worth recalling what the former Ambassador of Sweden said in response to a comment about the need to respect Zambia's sovereign rights by the former Minister of Finance during a pre-Consultative Group meeting in 1994. The Ambassador stated that every donor country accepted Zambia's sovereign right to determine its own policies. He added, however, that the Zambian government also had to accept that every donor country had the sovereign right to withhold aid whenever it encountered behavior in Zambia that breached acceptable norms.

The government does not have to accept foreign aid. It always has the option of adjusting its economic policies in ways that eliminate the need for aid. Yet, if the government decides that it does not want to make the necessary adjustments, it must expect to encounter some requirements and restrictions attached to the assistance it receives. These conditions can be negotiated, and the government should use the negotiations to its advantage. But, once agreed, the government should make a good faith effort to comply. The BS does not reflect an understanding of this principle.

Unfunded

In every budget, some unexpected expenditure will arise, some expenditure will not be made. Some revenue sources will over perform, some will under perform. Prudent budgeting requires conservatism in the assessment of revenue and expenditure. The 1998 budget was an attempt by the government to present a consolidated budget that included foreign financing. At the time the budget was framed, a large component of the financing had not been secured. Moreover, because of the need to meet prior conditions and conduct lengthy negotiations (including the staging of a Consultative Group meeting), the funding could not be secured until well into the budget year. Such an approach could be explained in two ways. The government was certain that the donor funds would be provided, or it served the strategic purpose of putting pressure on the donor community to provide the expected support.[29] In either case, prudent budgeting would require the government to have a credible fallback position. This was not done.

The budget contained a number of critical assumptions about the donor's willingness to finance several activities. These include civil service retrenchment (par. 106); balance of payments support for debt service (par. 99); reform of the rural credit system (par. 72); the revitalization of agricultural sector investment program (ASIP) (par. 52); and the implementation of several other sector investment programs (par. 56). Much of the project assistance in the budget is included as revenue and expenditure so that actual receipts do not affect the size of the budget deficit. That is not the case with the support for civil service retrenchment and debt service (including debt relief). It is here that a fallback strategy is needed. Even for project assistance, a fallback position for government capital expenditure in the absence of donor support would be prudent.

From past experience, the shortage of budgeted resources has been accommodated in five ways. These are: compression of RDCs and capital expenditures; domestic arrears; external arrears; running a smaller "domestic surplus" than anticipated; and domestic borrowing. Since none of these is a constructive economic response to the failure of external support to materialize, the government should have a contingency plan worked out in advance. The objective of such a plan is to minimize the damage to long run sustainable growth prospects created by the reduction in resources available. The BS provides no indication that the need for such a plan was anticipated. In view of the events that led to the collapse of the negotiations to sell ZCCM and the host of conditions that were linked to that outcome, this was a major oversight.

The BS is impressive in scope, detail, and direction. The budget is comprehensive, forward-looking, and ambitious. Its major weaknesses are that it is far too complex administratively and it is under-funded. For these reasons, the BS does not provide a coherent set of measures that meet the goals of the government's economic program or further the task of moving Zambia onto a path of sustained growth and development.

The policies contained in the BS represent admirable intentions but they are not implementable as they are currently formulated and financed. More important, the implementation of some key policies – completion of the privatization of ZCCM, public sector reform – were contingent on the actions of others over which the government had little immediate control.

The economic situation in Zambia could readily improve if the budget began to be used in constructive ways. Important changes could be made if three principles of budgeting were adopted. These are: keep it simple, ensure that it is fully financed, and make the goals realistic. A further consideration is to prepare a credible fallback position.
In the following section, we make suggestions on how to move the economy forward.

6. Further Thoughts on The Way Forward

We urge attention to six areas: revitalization of the mining sector; progress on the public sector reform program; improved macroeconomic management; continued promotion of exports; explicit attention to issues of governance; and reduced aid dependence. This section addresses each of these topics in detail.

Revitalization of the mining sector: In selling ZCCM, the government focused far too much on the price, and not on the benefits to the country of reviving the mining sector. The basic issue is how best to restore the mines to full production in the shortest time possible. If this is done, Zambia would once more begin to benefit from higher rates of income generation, employment, and wealth creation. Government revenue would also increase. The main issue with respect to mining has always been to take advantage of its capacity through its linkages within the economy to raise employment, restore income flows, generate additional foreign exchange, and enhance the nation's wealth. During the delay in the sale of ZCCM, the company lost hundreds of millions of dollars, the country's external debt has risen commensurately, and investment that could have generated employment, income, foreign exchange, and the accumulation of national wealth was delayed.

Since world copper prices are well below $1 per pound, recovery in Zambia's mining fortunes will not be dramatic. Nonetheless, with the mining sector under the management of a world class mining company that has finance, up-to-date technology, and effective management, the mines can begin the long (and much overdue) process of reconstruction and reorganization. That process alone will provide a major boost to the copperbelt and all activities related to mining. The main challenge for the government (and donors) will be to unravel ZCCM's losses in ways that do not inflict further damage on the economy. How much of this debt will be written off and how much will be paid by the donor community is not clear. If appropriately handled by the government most (if not all) of these losses will be absorbed by the donors. But, for that to happen, the government will have to demonstrate that it is making sustained progress in other dimensions of reform, especially macroeconomic management and governance.

Public Sector Reform: The main issues relating to the public sector reform program are how large a civil service is needed for effective government, what the aggregate wage bill should be, and whether that bill can be supported by the economy. The cost estimates should include both the transition costs such as those associated with retrenchment and the additional costs of paying a smaller civil service at higher rates on a sustained basis. Given Zambia's fiscal constraints, the objectives of the program and its costs must be clearly understood by decision-makers. The existing retrenchment package is expensive. The government is legally obliged to offer retrenched civil servants a lump-sum payment equal to two-thirds of their total pension. This can result in immediate payments equal to 3-6 times an employee's annual salary. For senior civil servants this can average around $50,000. The donors have indicated that they will support civil service reform. Given the pervasiveness of poverty in Zambia, costs of this magnitude are indefensible.

The government has to devise a more affordable strategy, either by offering voluntary packages, which circumvent the legal requirements, or by changing the law. An effective hiring freeze should be adopted until an affordable retrenchment arrangement can be put in place.

Another important issue is how to improve efficiency of the civil service. Three elements related to the civil service are a drag on economic recovery in Zambia. The first is the cost of the reform program itself. The government cannot afford the cost. Moreover, even if the donors were to pay for retrenchment, there are far better ways to use the resources. The second point is that the reduction in numbers of civil servants is much less important than raising the quality of services provided. For the quality of services to improve, the cheapest solution for government is to furlough unproductive workers on full pay but without access to future wage increases. (This possibility, already raised in Zambia in several contexts since 1992, has resurfaced in the Policy Framework Paper (PFP)). The third point is that the services actually provided by the civil service should relate only to activities that support and sustain growth and development. Clearly, government interference in markets and the maintenance of large numbers of embassies abroad do not meet this criterion.

Improve Macroeconomic Management: The fundamental issues with respect to macroeconomic management are to eliminate the budget deficit and to orchestrate a large sustained devaluation of the real exchange rate. Zambia's history since 1970 (when large-scale deficit financing first began) has shown that without a responsible approach to government finance (a crucial element of governance), nothing else in the macroeconomic picture will be consistent. Pressure has to be relieved on debt creation at all levels (including printing money). That is impossible while the government continues to run a budget deficit. Similarly, Zambia has little hope of regenerating the dynamism that it will require in its export and import-competing sectors without a major, sustained realignment of the real exchange rate.[30] Zambia's mines are no longer (as they once were) some of the lowest cost sources of copper in the world. Zambia's workers are no longer inexpensive relative to their productivity. Thus, the only way to reduce unit (labor) costs in a sustained way is through real exchange rate devaluation.

There are many ways that these changes can be implemented. Eliminating the deficit requires a mechanism such as a cash budget advanced by at least one month. Such a device would ensure that the budget remained in surplus irrespective of the pressure to spend.[31] Sharply devaluing the real exchange rate will require that the BoZ continue to manipulate the exchange rate (as it has done since mid-1995) but in ways that encourage devaluation rather than resists it. One immediate way to do this would be if the BoZ were to aggressively rebuild its external reserves.

Progress has been made in reducing the contributions of fiscal deficits to macroeconomic instability. But, problems remain with respect to the allocation of public expenditure and to overall expenditure control. Several activities will contribute to improved macroeconomic management. These include removing inefficiencies in the allocation of public expenditure, eliminating domestic arrears, and mobilizing additional resources domestically through a large budget surplus.

Efficient Allocation of Expenditure: With personal emoluments and interest on the domestic debt claiming increasing shares of government expenditure, the resources available for recurrent and capital expenditures have declined significantly. Recurrent expenditures have been below budgeted amounts in 1994, 1996, and 1997 (Economic Report 1997:Table 2.6). In real terms, recurrent expenditures have been severely cut. Domestically financed capital expenditures have been similarly squeezed. In 1997, wages and salaries (personal emoluments plus the wage adjustment) equaled 36 percent of government expenditure, interest on the domestic debt equaled 13 percent, while capital expenditure was only 8 percent and RDCs were 15.6 percent. RDCs were equivalent to 43 percent of wages in 1997. They roughly matched wages in the early 1990s.

Coming to grips with these problems through fundamental restructuring of the civil service is essential. In addition to the hiring freeze advocated above, a useful start would be to sharply reduce the number of ministries. The logistics of operating a government with close to thirty ministries, each with their complement of Deputy Ministers and support staff, prevents the government from functioning effectively. The same logic that has been used to justify the sale of State-Owned Enterprises applies to government ministries and departments. Those that are ineffective should be closed. Those that remain should have their goals drastically simplified. One operational goal should be to restore the ratio of RDCs to wage payments to its former level. Since the overall budget cannot be expanded, this implies that the wage bill has to be cut.

Eliminate Domestic Arrears: Several steps are needed. First, the outstanding stock of arrears has to be verified.[32] Confusion still exists among many officials how arrears are defined in relation to commitments. Second, adequate provision to clear existing arrears has to be made in the budget. If it will take more than a year to clear the outstanding arrears, provision needs to be made over several budgets. Third, procedures to avoid new arrears have to be followed.[33]

A variety of changes are required. Budget provisions related to RDCs need to be realistic. The expenditure of each ministry has to be fully monitored and budget allocations enforced with penalties applied at the level of the Controlling Officer. Since unexpected and *ad hoc* expenditures always arise, the contingency has to be large enough to realistically deal with the most urgent of these unexpected items.

Finally, the proposed computerized "commitments monitoring system" has to be installed and made operational. The full system is several years off. It is important that the interim system currently being developed bridges the gap.

Mobilize Domestic Resources through Increased Savings: For growth to accelerate, higher investment from both local and foreign resources is required. Many of the policies already discussed should help with this objective. Privatization of the mines, consistent and credible implementation of the reform program, fiscal discipline, and continued incentives for exports will encourage investment in profitable and efficient sectors in the economy.

Government actions must contribute to national savings. The "public good" dimensions of economic stability - low inflation, stable and relatively low interest rates, and an appropriately valued exchange rate - deserve the highest priority. On a benefit/cost basis, there is no program of deficit spending that the government can implement which will generate more social welfare than the benefits of sustained stability.[34]

There are a number of ways in which a major impact on the deficit could be achieved. Some domestic expenditure can be easily cut and should be targeted. Official travel and representation abroad should be slashed. The strategic under-funding of crucial items in the budget is simply window-dressing. The budget process needs to be realistic, with all strategic items in the budget at full cost. The retrenchment packages could be reworked.[35] Tax defaulters should be prosecuted to the full extent of the law. After the tax amnesty, it is time to act decisively against those who break the law. Indeed, for the tax amnesty to succeed, such action is essential. The "dire consequences" mentioned in the BS (par. 146) have to be given substance without fear or favor. The viability of the several sector investment programs should be reexamined. The demise of ASIP should caution the government about attempting such administratively intensive projects. The BS makes several references to revitalizing and reinvigorating ASIP (pars. 56,70,102). Given that ASIP was meant to be the government's "flagship" approach to sectoral growth when it was introduced, reasons for the difficulties need to be understood before the government embarks on several others, e.g., in education, health, and infrastructure. A preferable approach would be for the government to focus attention on providing quality coverage of the basics in education and health. A simplified agenda that fits within the financial and technical capacity of the government to deliver results over the long-term will have a greater impact on welfare and poverty reduction than the present scatter gun approach.

Continued Promotion of Exports: One area where the government's reforms have worked so far is the promotion of non-traditional exports. The major impetus has come from the liberalization of trade and the decontrol of the foreign exchange system. As a result of these major policy shifts, the incentive to produce for export has increased significantly over the preceding decade. This is a direct addition to national resources helping to close the 'resource gap'.

The government has to ensure that these incentives are not eroded. The 1998 budget called for the elimination of the import declaration fee on July 1, 1998, which effectively is a 5 percent across-the-board reduction in tariffs. Further reductions in nominal tariffs are expected over the next few years. In order to facilitate their implementation, ZRA has to improve tax compliance substantially so that government revenues are not adversely affected.

With respect to the exchange rate, the government needs to carefully monitor movements in the real exchange rate to ensure that Zambia's international competitiveness improves.[36] The government has been intervening to prevent the nominal exchange rate from depreciating during the last two years as a means of reducing pressure on domestic prices. This has produced a significant appreciation of the real exchange rate that has undermined Zambia's competitiveness. Such a policy is unsustainable and needs to be abandoned.

Promoting exports does not require explicit action by the government. A conducive setting for the expansion of exports will emerge if the government takes the measures needed to eliminate the budget deficit, depreciate the real exchange rate, and support the agricultural sector through improvements in basic infrastructure. Zambia's exporters are already linked to foreign markets and can gain access to finance if their potential output can be profitably marketed. Neither of these require new initiatives by the government. What it does require, however, is for the government to take seriously its pledge, first enunciated in the *MMD Manifesto* (1991) of "creating an enabling environment" for private sector activity.

Issues of Governance: The 1991 MMD *Manifesto* committed the Party to transparency, accountability, and honest administration. A majority of Zambian voters and the international donor community accepted those assurances. Thus, the issue of governance in Zambia should not be, as the PFP has stated, a matter of "...preparing a comprehensive Governance Program for discussion with its external partners" (IMF 1999:8). Somehow those who formulated the PFP have missed the point. Governance does not involve what Zambia's external partners urge upon Zambia's leaders. Experience gained elsewhere may prove useful, but at its most basic level political and economic governance is what Zambians do for themselves. If Zambians will not insist that their leaders behave forthrightly, honestly and humanely, they are the losers. No one else is. Moreover, if Zambia's leaders have to look abroad for international endorsement of their behavior, they have misunderstood what leadership entails.

The point is that governance rests on the relationship between those who lead and those who are led. If neither group has faith in the other, no amount of documents shared with external partners will turn a collection of politicians into a government able to promote sustained growth and development. As the MMD *Manifesto* already noted, that will require responsible, accountable behavior by both those who seek to govern and those who are being governed.

No doubt, this all takes time and practice. But, in Zambia's case, time is not on the government's side. It is almost nine years since the MMD party took office. Since then real per capita income in Zambia has declined by more than 30 percent. That collapse has occurred and continued because the government has remained unwilling to implement and sustain the types of policies that would promote growth and development. More than anything else, this is where governance has broken down. The program outlined above – eliminate the budget deficit, depreciate the real exchange rate, and stop interfering in agricultural markets – offers a way to begin to repair the damage.

Reduce Aid Dependence: A further means of improving governance would be for the government to take explicit steps to reduce its dependence on the donor community. A major benefit of formulating such a strategy is that it would require wide-ranging, positive, changes in government behavior. This recommendation is not made gratuitously. We recognize that Zambia is a poor country that under "normal circumstances" could benefit from international transfers. The problem is that since the early 1970s when large-scale international assistance to Zambia began, there has been neither growth nor development. Instead, international assistance has created a pathological setting that has blocked growth and development. Both the government and donor agencies have become enmeshed in a destructive cycle of adverse expectations. Government officials do not expect Zambia to move beyond aid in the foreseeable future. Donor officials have similar expectations. These expectations are regularly reinforced when foreign aid is used as financing of first, rather than last, resort. For evidence, one needs look no further than social expenditure. The areas that should have highest priority, and should be subject to the government's most intense efforts, are routinely financed by the donor community.[37]

In 1970, Zambia had minimal foreign assistance, low foreign debt, high rates of saving and investment, a positive "resource balance", a budget surplus, low inflation, and a creditable rate of per capita income growth. Comparisons with 1980, 1990, and 1996 reveal an entirely different picture. By the later dates, real per capita income had fallen, the rates of saving and investment had declined sharply, and foreign debt had risen to insupportable levels (see Table 1). Zambia had ceased relying on its own resources and had become acutely dependent on foreign aid. Association does not imply causation. But, in Zambia's case, the general collapse of the economy's ability to finance its own growth and development and general inability to move beyond the dependence on foreign assistance have been closely linked.

The flows of foreign resources have been so large that Zambia's whole approach to policy making is dominated by the need to keep those resources flowing. The 1998 budget included external financing equivalent to 35 percent of total expenditure (BS 1998 par.104).[38]

Zambia and its donors provide a case study of mutual aid dependence. Foreign aid has contributed to Zambia's economic problems because it has allowed the government (both UNIP and MMD) to finance imbalances rather than adjust. The way out of this impasse is for the donors and the government to adopt a set of explicit steps to reduce their mutual dependence.

It may seem premature to recommend that Zambia phase out foreign assistance especially when 35 percent of the budget is supposed to come from the donors and government officials are in the process of re-engaging the donors.[39] However, there is considerable evidence that foreign assistance at the levels provided to Zambia have been counter-productive.[40] In our view, the government and the donors should work out a program to phase out all extra-ordinary assistance over a fixed period. Such a program will focus the attention of the government and the donors on mobilizing domestic resources in sufficient quantities to compensate for the decline in donor assistance. This task will be made easier if the government eliminates the budget deficit and engineers a real devaluation of the kwacha so that the balance of payments deficit can begin to close.

The Zambian government is currently extremely dependent on the donor community. That dependence will become increasingly less significant when the government begins to formulate and implement policies that provide alternative sources of finance *and* when it takes the steps needed to eliminate the internal and external imbalances which generate the need for such large amounts of donor support. The government has raised the issue of aid by denying in the Budget Speech that it is aid-dependent. This provides an opportunity to debate the topic nationally to determine the type of policies that progressively reduce Zambia's aid dependence. The opportunity now exists to give substance to the Minister of Finance's claim that "… the people of Zambia do not want charity. They want a chance to move ahead" (BS par. 158). Restructuring the budget in ways that make it simple, realistic, and fully financed would be an ideal way to give them that chance.

If the government decides that it will formulate and implement an "aid exit" strategy, it will find essential the elements set out above. It is also worth noting that an exit from aid is impossible without an exit from debt. That, in turn, is impossible if the government continues to run deficits and attempts to maintain an overvalued real exchange rate. Both add to debt that the country cannot afford to service.

7. Concluding Comments

Zambia has the advantage of abundant natural resources (many of which have not been developed), adequate fertile land, and the basic infrastructure to support modern economic growth. The conventional approach, however, has been to assume that Zambia needs additional resources if it is to grow and develop. History has clearly shown that resources are not the constraint in Zambia. Over the last thirty years, the country has had access to large amounts of domestic and external resources. These have produced regression rather than growth. It is important that Zambia use available resources efficiently, effectively, and equitably.

Doing this is the basic challenge facing Zambia as it seeks a way forward. Can the Zambian government respond to this challenge? Will the government respond? It could if Zambia's leaders would make some consistent, coherent, and bold decisions about economic reform. After three decades of economic decline, what the government has to do is well known; whether it will do it remains uncertain. The suggestions we have provided offer a means of reducing that uncertainty by helping Zambia find the way forward onto a path of rapid growth and development.

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Endnotes

[1] For example, the *Economic Report* page 54 states that "Prospects for accelerated growth in the mining sector in 1998 are bright following the privatisation of the ZCCM." The difficulties completing the various agreements were not anticipated.

[2] This point was highlighted in an earlier review of the state of the Zambian economy (McPherson 1996).

[3] In the three years before its closure, Zambia Airways had lost close to $100 million. Its demise improved the balance of payments and raised Zambia's GDP.

[4] Meridien Bank Ltd. had been experiencing serious financial stress from the early part of 1994. Its capital and reserves had been less than 1 percent of deposits for an extended period. This situation had brought no response from the Bank of Zambia. Despite the appearance of a highly damaging article in the September 1994 issue of *Euromoney*, the BoZ management continued to portray Meridien Bank as being sound and in no need of intensive regulatory oversight. A silent run occurred in late 1994, and a major panic hit the bank in late January 1995.

[5] The IMF and Zambia reached agreement on a rights accumulation program (RAP) in July of 1992 (IMF Press Release No. 92/57). Under the RAP, Zambia could earn rights to clear its arrears with the IMF. The rights entitled Zambia to the first disbursement of a loan from the IMF under a successor arrangement. The RAP was completed on December 4, 1995.

[6] The ESAF program could not officially commence until the RAP had been completed. The first year of the ESAF was July 1995 to June 1996, with the first performance criteria established for December 31, 1995. With the completion of the RAP delayed until early December 1995, the ESAF benchmarks came into effect shortly after the ESAF was officially approved. Six of ten benchmarks were missed.

[7] At the official launching of the Zambia Revenue Authority on 1st April 1994, the Chairman of the Zambia Revenue Board stated that it was the Authority's intention to increase revenue collections by "500 percent". Some allowance needs to be made for hyperbole. Yet, ZRA's subsequent performance has shown that, after allowing for changes in tax rates and the tax base, there has been no perceptible increase in the real value of tax collections (Kasanga 1996).

[8] It is not clear what this has meant in a practical sense in Zambia. The BoZ has taken a pro-active stance to force interest rates down and keep the exchange rate stable. These actions are fully consistent with the government's goals. However, they exacerbate rather than improve monetary and financial stability.

[9] The MMD *Manifesto* (1991) noted (p.3):

> "The MMD recognises that the Zambian Public Service has been inefficient mainly due to politicisation and poor incentives..."; and (p.4) "The MMD is committed to privatisation in order to optimise resource utilisation, enhance the productivity and profitability of the public sector and assist in the reduction of the government deficit".

It also stated that, as part of adopting "strict financial management and sound budgetary control..." the MMD is committed to "...selling off as many state owned enterprises as possible..." (page 5).

[10] The formal sale was completed March 31, 2000.

[11] Lewis and McPherson (1996) review Zambia's history of exchange controls and the generally negative impact they had on the economy. Econometric evidence reported in McPherson and Rakovski (1998) shows that real exchange rate overvaluation has had a major negative impact on economic growth in Zambia.

[12] This is evident from the date in Table 1. Over the period 1974 to 1997, prices in Zambia increased by a

factor of 2048; the nominal money supply increased by a factor of 1475. The statistical association between the two variables has been positive and highly significant (McPherson and Rakovski 1998).

[13] In Zambia a domestic budget surplus does not necessarily imply that the budget results in the net reduction of government borrowing from the financial system. The domestic surplus is computed as revenue (excluding grants) minus current and capital expenditure excluding interest payments on foreign debt and the foreign component of capital expenditure. In practice, foreign financed capital expenditure is a "wash" but grants have not been adequate to cover foreign interest payments. (Foreign flows regularly pay amortization of foreign debts or debt relief is provided.) Thus, a domestic surplus may be offset (and over the last two years has been offset) by foreign interest payments uncovered by foreign aid. A further wrinkle on the financial impact of the domestic budget surplus has been the fact that for the last two years, the surplus has been matched by an equivalent amount of arrears. Thus, while scoring political points for running a surplus, the government has not been able to insulate the financial system from the budget. This partially explains why Zambia has had such high persistent inflation while running a budget surplus.

[14] In practice, the ministry could have accumulated a month's average funding in advance. This could have been achieved if the government, consistent with its commitment, had run a surplus. Failing that, the same effect could have been achieved by having each ministry cut its expenditure back by an average of two weeks. Neither of these actions was taken. Moreover, whenever the MoF appeared as though it had generated a surplus, some "pressing" expenditure always materialized.

[15] These accounts show a large volume of assets and liabilities which have been qualified because adequate verification could not be obtained.

[16] In the 1995 Budget, the statutory reserve requirement was reduced from 27 percent to 3 percent. This change dramatically lowered the tax on financial intermediation. To offset the potential monetary impact of releasing such a large amount of liquidity, the government issued statutory reserve bonds to banks. These paid market-based rates of interest and could be redeemed over a period of five years.

[17] Our communications with several commercial bank managers in August 1997 confirmed this point.

[18] The recent re-emergence of a parallel market in foreign exchange is evidence that the exchange rate, in particular, has not been market-determined.

[19] This has occurred despite the availability of large amounts of donor-sponsored training. That training has been long and short-term, both locally and abroad, together with a host of in-house and on-the-job capacity building. At a basic level, most of the skills needed to effectively manage the Zambian economy are available. The main problem is that the public service is so unwieldy and so disorganized that the efforts of those who have useful skills are dissipated.

[20] This has been evident for years. Output has been declining due largely to lack of investment, mismanagement, and the out-dated mining techniques used by ZCCM. The *Kienbaum Report* in 1993 showed that the mines were in poor shape. The government did not release this report. The World Bank experts in 1994 confirmed that ZCCM was in desperate shape. The most obvious evidence is the continued decline in copper production.

[21] Some officials have used this to argue that the government cannot afford to remove itself fully from agricultural marketing. Strategic questions, however, are overlooked. The private sector response has been hesitant, precisely because the government position has been ambivalent. To stimulate confidence and induce the desired response, the government has to make an unambiguous commitment to leave agricultural marketing to the private sector. Given past government behavior, private operators will remain skeptical.

[22] The study "Restructuring in the Midst of Crisis" (Government of the Republic of Zambia 1984) highlighted the problems created by the under-funding of recurrent costs. A similar point was made in the "New Economic Recovery Program" (Government of the Republic of Zambia 1989).

[23] Based on its expenditure history, the government could have easily cut its budget estimate for capital expenditure, thereby reducing the need for additional revenue effort or expenditure cuts. This stratagem, however, was excluded because it would have openly advertised that the government was only making a minimal contribution to capital expenditure. In the event, the predictable cuts in capital expenditure occurred.

[24] The minister, in fact, stated that the goals were not "ambitious" enough (par.156). We disagree. As we have argued in the text, the budget was well beyond the government's capacity to implement.

[25] These include privatization of ZCCM (par. 24); reform of the public service (pars. 51,56); meeting the conditions agreed with the IMF (par. 55); reducing inflation to single digits (part 88); controlling monetary growth (par. 57); implementing the Agricultural Sector Improvement Program (par. 70); liberalizing petroleum marketing and distribution (pars. 77,78); and refraining from interfering with exchange rates (pars. 58,98) and agricultural marketing (par. 71).

[26] This raised the question of whether the main barrier to reducing poverty is market failure through the lack of economic growth or bureaucratic failure through the collapse of official poverty reduction efforts (Wolf 1988; Squire 1990). Experience in Zambia (and elsewhere in Africa) shows that government-directed programs do not reduce poverty on a sustained basis (Stiglitz and Squire 1998). By far, the greatest source of poverty in Zambia has been due to economic collapse. That can only be overcome by a growth strategy. Several have been promised in Zambia. So far, all have foundered due to poor implementation.

[27] It is not clear where the figure of 70 percent of Zambians in poverty comes from. The *World Development Indicators* (World Bank 1998:Table 2.3) noted that in 1993, 86.3 percent of Zambians were below the "national poverty line". Since per capita real income declined since then, the proportion in poverty could not have fallen. The challenge of moving to 50 percent poverty by the year 2004 will be more demanding than the government anticipated.

[28] The quote is: "Mr. Speaker, Sir, I have received numerous complaints from the textile producers about the influx of second-hand clothes which is creating unfair competition for them. In order to revive the textile industry I am proposing the minimum duty for second hand clothes be increased from $1.5 to $5 per kilogram." The government subsequently changed its mind about raising this tax.

[29] This is the international equivalent of what Smithies (1955) called a "coercive deficit". However, it only works when both parties are willing to play the game of bluff involved. Due to the Zambian government's deteriorating record on governance issue, the aid agencies have been less willing to do that.

[30] Evidence for this may be found in McPherson and Rakovski (1999)

[31] The cash budget advanced by one month implies that the government operates with a full month's revenue as a cushion. For example, expenditure (including commitments) in June would be limited to revenue collected in April. The cash budget that operated in Zambia during 1993 and 1994 operated in a way that kept revenue ahead of expenditure by roughly two weeks. This system broke down, not because it was not working, or could not work. Rather, it became inconvenient to senior government officials to build up and maintain a cushion of revenue. The cash budget broke down as the government began funding its operations with monthly advances from the BoZ and having BoZ pay government debt service outside the budget.

[32] Prior to 1993, the problem of arrears did not arise. All ministries and departments operated "X-accounts" at the central bank into which all outstanding bills were swept at the end of each financial year. Domestic arrears only became a problem as the government attempted to limit the amount of resources released to each department and ministry.

[33] The 1994 BS noted that arrears had been a problem in 1993. During 1994, arrears of K17 billion were

paid. In 1995, the government paid arrears of K22 billion; in 1996, the total was K42 billion. In 1997, K68.9 billion in arrears were cleared even though there was no provision for arrears in the 1997 budget. Whether these have in fact all been arrears or expenditure unacceptable to the IMF disguised as arrears is on open question.

[34] In a meeting of the Technical Committee of Economic Ministers in November 1992, one of us asked then Minister of Finance Emmanuel Kasonde whether the government had ever thought of helping Zambia's poor by *not* spending money. At the time, inflation, fueled by deficit spending, was rising towards a rate of 200 percent per annum. It was a small step from this comment to the argument that since "inflation is the cruelest tax on the poor" the government had a social responsibility to minimize that tax by creating the conditions necessary for low inflation. Two months later, the government responded by introducing the cash budget.

[35] The K116 billion allocated for retrenchment is too poorly defined. There is no indication in the BS of how many civil servants will be covered, whether the government or the donors are getting "value for money", or how many years allocations of this size will be needed to "complete" the retrenchment. One option that always exists is to send the redundant staff on paid leave until they retire. This does not achieve the target of "reducing" the civil service, but it saves the up-front costs which under present circumstances in Zambia, cannot be justified.

[36] The IMF regularly emphasizes this point.

[37] For evidence, readers need only consult recent *Economic Reports* or *Public Expenditure Reviews* to see that the bulk of the financing (more than 95 percent) for development activities in areas such as education, health and infrastructure is provided by the donors.

[38] Nonetheless, though his expenditure plans were cast this way, the Minister claimed that Zambia is not dependent on foreign aid. Indeed, he was somewhat more subtle. The Minister actually stated: "Zambia's case is not one of growing dependency on donor support" (BS 1998 par. 159). This may be true but Zambia's dependence on aid remains exceedingly high, something that is inconsistent with the statement about aid dependence made in the 1996 MMD *Manifesto.* That document stated that Zambia needed to reduce its dependence on foreign assistance so that (among other things) it could take full control over its policies.

[39] The *Times of Zambia* (12th May, 1998) had a story "Zambia plans Club 'assault'" which explained how the Zambian team would make the case to the donors in order to restore the flow of aid.

[40] Though the World Bank continues to lend heavily to Zambia, recent assessments of the contribution of Bank support to Zambia have been exceedingly negative (World Bank 1996).

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